

UK recovery moves into lower gear after sluggish August growth

The UK economy may have weathered the Delta Covid-19 wave better than we'd feared, but the recovery is nevertheless slowing. This is one of the reasons why we think the Bank of England will wait until 2022 before hiking - but perhaps more importantly - it implies markets may be wrong to price interest rates at 1% or higher in the next few years

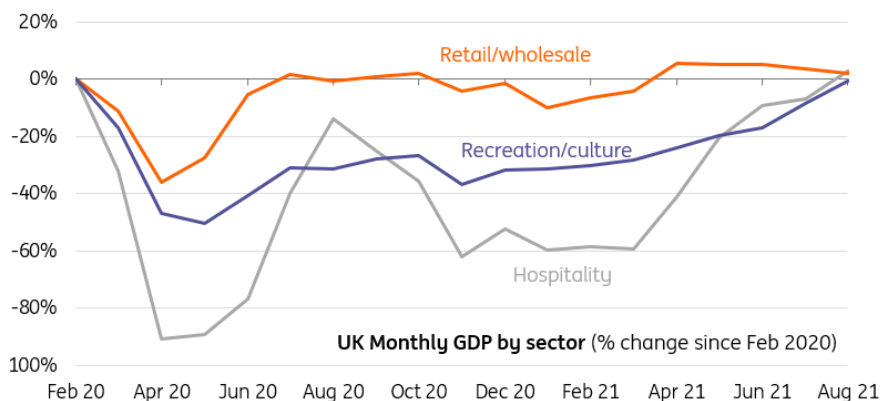


Source: Shutterstock

On the face of it, August was only a little better than July for the UK economy – at least compared to the bumper growth of the second quarter. 0.4% growth in August followed a 0.1% contraction in July, and means that the overall third-quarter GDP figure is set to come in around half the Bank of England's 3% forecast.

Having said that, the underlying details offer a slightly brighter picture. Activity in hospitality and recreation/culture is essentially back to pre-virus levels, which suggests that the economy weathered the Delta Covid-19 wave better than we'd feared at the time. The recent retracement in retail activity is less a reflection of Covid consumer caution, and more a simple rebalancing of spending back towards services.

Consumer services activity is more or less back to pre-virus levels



Source: Macrobond, ING

And while the ‘pingdemic’ undoubtedly caused issue for firms earlier in the summer, a 0.5% bounceback in manufacturing output reflects an improvement in conditions for car makers – though in reality, the global supply chain problems afflicting the industry are unlikely to disappear any time soon.

All of this suggests that ‘stagflation’ is not the right word to describe the UK right now – even if high-frequency data indicates the recovery is going to be much more gradual from now on. Fourth-quarter growth will get a boost from the return to schools and the noticeable increase in office activity. But it’s still likely to take until early next year before economic activity hits pre-virus levels, and our 1% growth forecast for the fourth quarter is again lower than the BoE’s. A lot will also depend on health output, which slid 4% in August and is intrinsically linked to the vast Covid-19 activity.

Still, the wider backdrop is one of growing consumer headwinds, especially for lower-income workers, who face a perfect storm of tighter fiscal policy, rising energy prices, and some turbulence on the back of the furlough end date.

Bank of England likely to wait until 2022 before hiking

Recent BoE commentary suggests growth is unlikely to be the biggest factor in the committee's decision to hike interest rates over coming months – though it does offer a reason for caution. We still suspect policymakers will wait until 2022, when more information on wage growth will be available, before hiking.

But perhaps the bigger takeaway for markets is that the path of future rate hikes is unlikely to be as steep or lengthy as is currently priced. Investors now expect the interest rate to ultimately hit 1%, which implies that the BoE will also have started shrinking its balance sheet – and potentially could even begin actively selling gilts back into the market.

Given Bank rate never reached that level in the aftermath of the financial crisis, and with the recovery set to be a steadier process from now on, we think current market pricing for two/three years ahead has gone too far.

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